HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref.: B1/15C
B1/21C

1 April 2011

The Chief Executive
All Authorized Institutions

Dear Sir / Madam,

Supervisory Policy Manual (SPM) –
LM-1 "Liquidity Risk Management" (Revised)
LM-2 "Sound Systems and Controls for Liquidity Risk Management"

I am writing to inform you that, following consultation with the two industry associations, the Monetary Authority is issuing today the above SPM modules as statutory guidelines by notice in the Gazette under section 16(10) of the Banking Ordinance.

Background

The HKMA is adopting a phased approach to enhancing its liquidity regime having regard to the latest developments in international standards for the regulation of liquidity risks inherent in banking operations. As an important part of this process, the HKMA has developed LM-2 and revised LM-1 for the purpose of implementing the system and control standards set out in the *Principles for Sound Liquidity Risk Management and Supervision ("Liquidity Sound Principles")* released by the Basel Committee on Banking Supervision in September 2008.

LM-2

This module provides a detailed description of the system and control standards for the governance, risk management and disclosure of liquidity risk that AIs are expected to have in place. Many of these standards build upon the corresponding standards in LM-1, with appropriate elaboration and enhancements to align more closely with the *Liquidity Sound Principles* which are themselves designed to address liquidity risk management weaknesses identified in the recent financial crisis. Compliance with the standards in LM-2 should help ensure that AIs have a sufficiently robust liquidity risk management framework to withstand severe liquidity shocks.

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The following provides a high-level summary of the key requirements in LM-2:

(i) the Board of Directors of an AI should determine and articulate clearly the AI's liquidity risk tolerance, describing the types and magnitude of liquidity risk that the AI is willing to assume under normal and stressed conditions. Senior management should be responsible for setting and implementing the AI's liquidity strategy, policies and practices in accordance with the stated risk tolerance;

(ii) senior management of an AI should ensure that there is an appropriate internal risk pricing framework to enable liquidity costs, benefits and risks to be properly measured and attributed to relevant business activities so that line management incentives are consistent with, and reinforce, the AI's liquidity risk tolerance and business strategy;

(iii) an AI should adopt a comprehensive approach to liquidity risk measurement and management, encompassing the full range of liquidity risks to which the AI is exposed across business lines, legal entities and currencies as well as covering assets, liabilities and off-balance sheet exposures (including contingent liquidity risks that may arise from securitization or other activities);

(iv) an AI should have in place an appropriate funding strategy that provides for effective diversification of the AI's funding sources and a process for regularly gauging the AI's fund-raising capacity from each of the sources;

(v) an AI should actively manage intraday liquidity risks, taking into account collateral needs and time-critical cash flows resulting in particular from the AI's participation in payment and settlement systems designed to achieve intraday finality (such as real-time gross settlement systems);

(vi) an AI's stress-testing for liquidity risk should adequately capture severe but plausible stress scenarios, including prolonged market-wide disruptions (in addition to idiosyncratic shocks), with consideration of "second-round" effects (e.g. likely behavioural responses of other affected financial institutions);

(vii) an AI should devise a robust and operational contingency funding plan that takes sufficient account of the AI's stress-testing results and incorporates realistic assumptions about contingency funding sources;

(viii) an AI should maintain an adequate liquidity cushion of unencumbered, high-quality liquid assets that can be swiftly sold or pledged to meet funding needs under severe stress scenarios;

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(ix) the approach to managing an AI's intragroup liquidity risks (especially in the case of a cross-border banking group) should recognise and take into account the limitations on the transferability of funding and collateral to the AI from other group entities across borders (such as law and regulations, effects of bank resolution regimes or other jurisdiction-specific restrictions); and

(x) an AI should enhance its liquidity risk disclosures to enable market participants to make an informed judgement about the soundness of the AI's liquidity risk management system and liquidity position. The HKMA does not intend to prescribe minimum liquidity risk disclosure requirements at this stage, although some recommendations for disclosure are included in the module. After sufficient implementation experience in respect of the module has been gathered, the HKMA will consider prescribing minimum disclosure requirements (e.g. through amending the Banking (Disclosure) Rules) to reinforce the effectiveness of the standards.

LM-1

As the issue of LM-2 will render obsolete certain system and control requirements of LM-1, amendments have been made to the latter to reflect this (e.g. by removing the superseded parts to an "archive section" at the end of the module). The remaining parts of LM-1, which mainly concern the HKMA's supervisory approach and the minimum liquidity ratio requirement under the Banking Ordinance, have been slightly revised to tally with the LM-2 standards. The HKMA intends to further revise and expand these parts in due course as other enhancements are introduced into the liquidity regime.

Implementation

With the issue of LM-2, AIs will be expected to upgrade their existing systems and controls in respect of any deficiencies identified by reference to the new standards as soon as practicable, to an extent that is commensurate with their nature, scale and complexity of business. In light of the time this process may take, LM-2 expressly provides for AIs to develop and agree with the HKMA an implementation plan within four months, and a further grace period of up to 12 months, as appropriate, for AIs to complete any necessary changes to remedy any deficiencies. AIs will however be given a longer period for implementing the liquidity cushion requirements with the implementation date to be further announced by the HKMA. The HKMA will monitor AIs' implementation progress.

On-line access

The SPM modules are accessible on-line under the icon for "Supervisory Policy Manual" on the HKMA's public (http://www.info.gov.hk/hkma) and private (http://www.stet.finnet.hk/index.htm) websites.

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Contacts

Should you have any queries regarding the SPM modules, please feel free to contact Rita Yeung on 2878-1388 or Richard Chu on 2878-8276.

Yours faithfully,

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FSTB (Attn: Ms Natalie Li)